UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
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SYNCORA GUARANTEE INC.,

Plaintiff,

v. 09 CV 3106 (PAC)

EMC MORTGAGE CORPORATION,

Defendant.

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New York, N.Y.
June 13, 2012
2:43 p.m.

Before:

HON. PAUL A. CROTTY

District Judge

APPEARANCES

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(In open court; case called)

THE COURT: Are you going to be arguing today, Mr. Forlenza?

MR. FORLENZA: I am, your Honor.

THE COURT: And Mr. Sacks?

MR. SACKS: Yes, your Honor.

THE COURT: How much time do you need, Mr. Forlenza?

MR. FORLENZA: Well we have two points, Judge. I would think altogether 30 minutes or so, maybe 40 at the most.

THE COURT: Not 40.

Mr. Sacks, how about you?

MR. SACKS: Depends on what Mr. Forlenza says, your Honor. So it's hard for me to estimate. But I'll be guided by your judgment as to how much you want to hear and don't want to hear.

THE COURT: All right. Mr. Forlenza, go ahead.

MR. FORLENZA: Thank you very much, your Honor.

Judge, there are two different issues.

The first is the repurchase protocols construction; and the second is the availability of rescissory damages for a material breach.

Would you prefer that when I finish the first point you hear from Mr. Sacks so there's some continuity?

THE COURT: I think that would be best, yes.

MR. FORLENZA: Okay. I'll do that.

THE COURT: Is that all right with you, Mr. Sacks?

MR. SACKS: It is, your Honor, yes.

MR. FORLENZA: Thank you, Judge.

Your Honor will recall that early on in the case you asked counsel to come up with some ways of trying to allow this Court to efficiently try this case in which the plaintiff is alleging that over 8,000 loans are defective because of warranty breaches. And we came up with a few legal issues that we thought would accomplish that.

We identified the first one. And you ruled on that last year when you held in March that the repurchase protocol in the MLPA was not the exclusive remedy for Syncora for breaches of representations and warranties.

The two declarations we seek today, Judge, will avoid the necessity of having to engage in hundreds, thousands of mini trials to enable Syncora to prove its two main claims.

First, the damage claim for the total frustration by EMC of the repurchase protocol; and the second, a monetary award in the form of rescissory damages for the material breach of the I&I.

So let me start with the repurchase protocol.

The issue before the court is, on this, is when and how are EMC's obligations under the repurchase protocol triggered, that is to say, its obligations to cure, repurchase, or replace defective loans.

The ruling we seek is that those obligations are triggered at the time of the warranty breach which -- or let me state it differently.

The obligations are triggered at the time the loans that were warrantied are breached in a way that increases the risk of those loans.

Now the time of breach is at the closing because these warranties are related to the risk attributes of the loans, and those are warranties of fact existing at the time of closing. So if, in fact, at the time of closing the breaches -- sorry, the facts are not as represented and warranted, that's when the breach is complete.

The warranties, because they cover the risk attributes, in order to trigger the obligations to cure, replace, repurchase, have to be a breach that causes the loan to be become riskier.

THE COURT: You're using an insurance analogy, correct? You know, you have to judge the risk at the time of the closing?

MR. FORLENZA: Absolutely, your Honor.

THE COURT: What do you say then of Mr. Sacks' position that you need something more than that?

MR. FORLENZA: Well, EMC doesn't challenge the fact that the breach is complete at the time of the closing. It says that -- I think it's a rather extraordinary proposition,

particularly when you look at the purpose and the language of the protocol.

EMC takes the position that upon the discovery -- let's say the day after the closing -- of a breach that is egregious, a breach which dramatically increases the risk profile of the loan -- the borrower has fabricated income by a multiple of ten -- that although that loan is clearly defective, they have no obligation to even cure it, let alone replace it or repurchase it, until you wait for two things to happen which could take a long time: One that it actually defaults; and two, that you establish that the breach was the cause of the default.

And we take the position, your Honor, that when you take the plain meaning of the words used by the parties, you simply cannot justify that construction. Let me tell you --

THE COURT: The plain meaning is set in the MLPA and the I&I.

MR. FORLENZA: Well, yes.

Yes. The repurchase protocol is in the MLPA, incorporated into the I&I.

Can I hand up that language to your Honor?

THE COURT: No. Just tell me where it is.

MR. FORLENZA: Section seven.

Do you need me to cite to you the brief, your Honor, or the exhibit? I'm not sure I can at the moment.

Page seven of our opening brief.

THE COURT: Okay.

MR. FORLENZA: What you'll see, your Honor -- sorry. Let me let you get there.

MR. SACKS: Your Honor, Exhibit 3 of Mr. Forlenza's declaration is the MLPA. That I believe has not been -- section seven.

THE COURT: Thank you, Mr. Sacks.

MR. FORLENZA: I would add, your Honor, this is not just insurance law but it is basic warranty law in general, contract warranty law.

So the question, your Honor, is what is the plain meaning of the words used. And if you look at the first paragraph and it begins "upon discovery or receipt of notice," do you see that, Judge?

THE COURT: You're in section seven?

MR. FORLENZA: Yes, your Honor. I've actually highlighted it -- are you sure you don't want me to show you this?

THE COURT: I've got a highlighted version myself. I wonder if we have the same highlights.

MR. FORLENZA: So what you'll see, Judge, is that there are two triggers for the remedial obligation of EMC.

First, there's got to be a breach of a rep or a warranty. Then the first trigger is: Which materially and

adversely affects the value of the interests of the purchaser, noteholders, indentured trustees, or the note insured in any of the HELOCs. And then the second trigger, alternatively: Or which adversely affects the interests of the note insurer. So the language that's common to both of these, which is the language in issue, is -- it's in the second trigger exclusively in the sense there are no other words: A breach which adversely affects the interests of the note insurer.

Now, your Honor, the plain meaning of that word "interest," particularly in the context of an insurer, is inclusive. It's broad. That is to say, it is not restrictive.

They take the position that the insurer has no interest in the credit quality, in the accuracy of representations and warranties regarding risk attributes of the collateral that is the sole source of the funds for their insurance obligation.

I think that is an utterly unreasonable position.

After all, Judge, as we point out in our brief, risk is the business of insurers. It's the thing that they are in business for: Managing risk, evaluating risk. How do they do that? They do it by warranties.

And a note insurer in an asset-backed security, Judge, its vital interest is in the risk attributes of the underlying collateral. That's why it got, in this case, 71 warranties regarding those risk attributes.

So to say that the note insurers' interests are not affected when a loan is not as represented but is, let's say dramatically more risky, I think is to distort the meaning of the word interest.

But there's another point, Judge. As your Honor is aware, the courts often will take a party's proposed interpretation of construction and reject it by looking at the words used and then reach a conclusion that if the parties intended that construction, they would have used the words reflecting it.

Judge Leisure did it in the case Chockful of Nuts in the Second Circuit and New York Court of Appeals in Riverside South.

In this case, typically the Court has to come up with those words. The Court says look if the parties really intended X, they could have used these words.

Here EMC has made it easy for us. EMC itself identifies in its brief the very words that the parties would, could, and should have used to reflect their construction.

Their construction is -- and it's laid out at page three of the brief, which I'll read into the record. They say as follow unequivocally, Judge. Page three of their brief they say, "Unless and until the loan becomes delinquent, defaults or is otherwise unable to generate its scheduled payments, thereby resulting in a loss to the trust, Syncora's interest cannot be

adversely affected."

In other words, Judge, what they're saying is that the way you should read the repurchase provision is along these lines. And I'll paraphrase but using exactly their words. That repurchase is required upon discovery or notification of a breach when, as a result of a breach of the loan, quote -- this is their words -- becomes delinquent, defaults or is otherwise unable to generate a scheduled payment, thereby resulting in a loss to the trust.

They want to replace the words "adversely affects the interest" with the phrase "thereby resulting in a loss to the trust."

Judge, try to imagine the meaning --

THE COURT: The words that you're quoting there and positing that they want in the contract are obviously not there in the contract.

MR. FORLENZA: Exactly. Exactly.

What I'm saying -- ask your Honor to do is try to imagine, Judge, a meeting of Bear Stearns and EMC executives with their securitization counsel coming up with the language in the contract. And the first thing they do is they decide there's going to be one single event, one type of breach that triggers EMC's obligations. And that's going to be a breach resulting in a loss to the trust.

Now imagine that group deciding how to articulate

that. And instead of putting in the brief -- sorry, into the clause "a breach which results in a loss to the trust," they say no, no. It would be far better and clearer to come up with the phrase "adversely affects the interests of the note insurer."

It's preposterous. It's a litigation construct.

It makes no sense that these parties, if this is what they meant, wouldn't have used the precise words that convey that message. Because, as I say, they use "interest of a note insurer" which is all about risk.

There is no rational explanation for using "adversely affects the interest" instead of resulting in a loss to the trust.

The words that litigation counsel came up with could easily have been used by their corporate counsel, if it was truly the intent.

I say to your Honor you don't have to look past the language that they could have used because that shows that that's not the parties' intent. And it certainly shows it when you give the word interest and interest of a note insurer its plain meaning.

There's a second basis, Judge.

You pointed out in your earlier opinion that the Court can and should, in construing the contract, consider other provisions that are relevant in other related contracts. And

we have that in this case.

The sale and service agreement has a section 2.05. And 2.05 completely contradicts their core position, the predicate, that the repurchase protocol does not contemplate the repurchase, cure or replacement of defective loans that are still performing. You've got to wait until they default.

And section 2.05, which I'm not sure we've quoted in full and I really would like to hand up one demonstrative, your Honor. I think it would be very helpful. May I do that?

THE COURT: Yes.

MR. FORLENZA: 2.05 and the treasury regs, please.

Now you'll see Judge, again, I've highlighted. Section 2.05 of the SSA makes explicit reference to the repurchase provision in the MLPA as well as a repurchase provision in the SSA. And it addresses a situation that EMC posits doesn't happen. It addresses a situation, and I boldfaced it, with respect to any --

THE COURT: I highlighted mine.

MR. FORLENZA: We're on the same wavelength.

It addresses a situation where a HELOC is not in default or as to which default is not reasonably foreseeable; in other words, a defective obligation that's still performing, a defective mortgage still performing.

And 2.05 says you can replace or repurchase such a loan but only if it's accompanied by an opinion of counsel that

replacing a defective performing loan does not have adverse tax consequences. And there are tax regulations that address that. Congress didn't want the REMIC to be able to -- shuffle loans in and out of a REMIC.

So the repurchase -- sorry, the tax regulations provide that performing defective loans can be replaced or repurchased without adverse tax consequences if they meet the definition of, quote, defective obligation.

Now, EMC says well 2.05 has nothing to do with this situation because the regulations, they only address extraordinary or exceptional circumstances. And then they say, quote, which here have nothing to do with EMC's put backs. But when you look at the regulation you see it has everything to do with the put backs. Why is that?

If you look at the bottom, your Honor.

THE COURT: Yes.

MR. FORLENZA: Treasury regulations. They define a defective obligation in one of two ways or one of two categories.

A defective obligation is a mortgage subject to any of the following defects. And the first one is the defaulting loan. If it's a loan that's in default or likely to default, it's defective.

But then they categorize three different ways in which a performing loan meets the definition of a defective

obligation. And as you see (iv) it's a mortgage that does not conform to a customary representation or warranty given by the sponsor or the prior owner of the mortgage regarding the characteristics of the mortgage.

Judge, every one of our put backs meets that definition. They're all put back because they breach the warranties of EMC.

And EMC has never suggested that their warranties aren't customary. And if they ever did, you could take judicial notice from the scores of litigation of RMBS that they are customary. So 2.05 clearly contradicts their position.

Now let me turn very briefly, Judge, to the purpose of the protocol.

THE COURT: Are you coming to a close now? I want to hear from Mr. Sacks.

MR. FORLENZA: Very quickly.

Your Honor described the repurchase protocol in your earlier decision as follows. You said it was a low powered sanction for bad mortgages that slipped through the cracks and a narrow remedy, etc., etc.

The point we make, Judge, is that when you look at the words and the purpose of that protocol, it's a classic example or provision dealing with the seller of a warranted product. If it's defective, you fix it, you replace it, or you repurchase it. That's the purpose of it. It's got provisions

of prompt notice. It's got a 90-day provision for fixing or replacing. It anticipates and facilitates early resolution, hopefully so you can avoid a loss occurring. You cure it before that.

But their position is you can never use the repurchase protocol to avoid a loss because loss is a condition precedent to any obligation, which makes no sense whatsoever. If you take their construction under the repurchase protocol, there is no obligation for prompt notice. It could be years later. There is no exchange of information to try to resolve it amicably because you've got to wait until it defaults and then get into a dispute, usually through litigation, to resolve it. There is no ability to avoid a loss. You've got to wait for the loss and then fight over what caused it.

Their construction puts this repurchase protocol on its head. It simply makes no sense.

Thank you.

THE COURT: Thank you.

Mr. Sacks.

MR. SACKS: Your Honor, I too have a couple of demonstratives. The one I'm going to refer to on this particular issue is in the middle of this packet, if I could hand it up to you.

THE COURT: Yes.

MR. SACKS: I will try to be relatively brief, your

Honor, but there are a couple of points that I think I do need to cover.

Mr. Forlenza has made a very nice argument, but it violates -- we're on summary judgment. It's his argument as to how this clause should be construed. The are clearly multiple different interpretations of this clause that cannot be decided as a matter of law in his favor.

While I suggest he is clearly wrong and that you might be able to decide it against him, clearly you do not have the ability on a motion for summary judgment to decide that this clause should be construed in his favor because there are countervailing interpretations, which are reasonable, and the evidence presented on this motion does not preclude our interpretation. Indeed, I suggest it supports our interpretation.

A couple of points. First of all, unlike --

THE COURT: Your point, Mr. Sacks, is that the language of the MLPA and the I&I and the sales and service agreement is ambiguous?

MR. SACKS: Correct, your Honor.

THE COURT: We should take parol evidence on it?

MR. SACKS: At best it's ambiguous, your Honor. At best.

I think you could -- I personally think that you could, in context, conclude that it is compelling evidence of

our interpretation of the words. But at best it's ambiguous. And I think that on a motion for summary judgment -- at this point we have not moved for summary judgment. While I think you could make a determination against Mr. Forlenza as a matter of law, the easiest thing to do is leave this for trial to hear what the parties' conflicting interpretations are.

THE COURT: And a jury of twelve would be able to parse this issue?

MR. SACKS: I actually think it's your Honor in this particular case. It's not a jury trial.

So your Honor will have to do it. And in terms of parsing it, I don't think it's a very complex issue. It's a straightforward contractual interpretation issue. And I would like to show you the reasons why.

THE COURT: Go ahead. I'd like to hear them.

MR. SACKS: First of all, your Honor, let me just say one thing, because Mr. Forlenza says it time and time again as though these rulings are going to assist you in avoiding a trial or a complex trial.

We are not going to have tons of mini-trials on individual loans. We got you loud and clear on that. And this case, no matter whether his interpretation is correct or our interpretation is correct, can be tried in an effective, efficient way, the way sophisticated lawyers try sophisticated business trials. That's not what this motion is about.

This motion involves a claim in which they are seeking legal damages. Not equitable relief. But they are seeking damages in this particular case. They're seeking damages under the repurchase protocol here.

To prevail on a damages claim for breach of contract they have to show we had an obligation to repurchase, that we breached the repurchase obligation, and they suffered damages as a result of it.

Damages are economic harm; i.e., they lost money as a result of our breach of contract. That's the context in which this repurchase protocol claim comes to the Court.

The obligation to repurchase under the plain language of the contract consists of two things: First, a breach of a representation and warranty; and second, a separate requirement and collective requirement which is that the breach adversely affected the interests of Syncora.

They point to language. They point to purpose. They point to case law. And they point to extrinsic evidence. All four of those favor our interpretation under this.

First of all, Mr. Forlenza has talked about an insurer's interest in the abstract. We're talking about the insurer's interest as it was meant to be referenced under the terms of this contract. Insurers can have many different interests. They can have interest in risks. They can have interest in insurability. They can have interest in whether

legislation is passed. But we're talking about their interest in this transaction. That's what -- this clause is a provision of the transaction. What is their interest in this transaction that is going to be adversely affected?

The interest in this transaction, given their role, is solely that the HELOCs generate enough cash flows to cover the obligations to investors so they don't ever have to pay. Their interest is in the cash flows that the loans generate.

Syncora doesn't own the loans in this case. It's not entitled to payments from the loans in this case. It was paid a premium up front. All it cares about is the cash flows. It's only interest in this transaction is in the cash flows from the HELOCs in this case.

Now, what's an adverse effect?

So that's --

THE COURT: Why do they rely then on representations and warranties? Why did you provide the representations and warranties? You should just have given them a cash flow chart.

MR. SACKS: Because those representations and warranties could affect the cash flows. Those representations and warranties, there could be a breach of a representation and warranty that could cause a loan to default.

THE COURT: What if they turn out, Mr. Sacks, to be wholly inaccurate? The representations and warranties?

MR. SACKS: As to all ten thousand loans?

THE COURT: Well, say a thousand loans.

MR. SACKS: That's -- well, your Honor, that's interesting you say that because I have testimony which I could -- I can hand up to your Honor -- it was taken after this motion was filed in this case -- where their witness testified that she was aware that seven percent of the -- based on the due diligence that was done, that seven percent of the loans in this case might breach the representations and warranties. That's seven hundred loans.

THE COURT: That's the stress test?

MR. SACKS: No. That's not the stress test.

The diligence that they did before entering into -- that we did, and they reviewed before entering into this transaction demonstrated that seven percent of the loans that went into the transaction, if they were representative of what was looked at in due diligence, might breach representations and warranties.

The parties -- this is why this is not a summary judgment issue, your Honor. That's why the parties understood -- these are sophisticated parties. This is a provision that was intended to effect, if a loan defaulted or if a loan somehow for another reason we posited in our brief usury, your Honor, if something happened that caused the cash flows to be affected because of a loan in breach of a representation and warranty and they gave us notice, we have an

obligation to repurchase.

But there is a requirement here of adverse effect. It's the second element. It's not just breach.

And, remember, this claim, your Honor, is not their claim for equitable relief which we're going to get to in a minute.

THE COURT: Yes.

MR. SACKS: This is a claim under the repurchase protocol for damages, legal damages. Not equitable relief.

So, they need to meet the requirements of the repurchase protocol. The second element is an adverse effect on their interest.

You don't need a theoretical or hypothetical or potential adverse effect. But it's an actual adverse effect.

They want it to say: That may adversely affect its interests in this transaction. It may affect it. Could have an impact on it.

Because risk of loss isn't actual loss. There are no damages if a loan has a higher risk of loss but it doesn't default and does exactly what it was supposed to do.

Remember, this is the damage claim. This is not an equitable relief claim.

So they have to show they suffered pecuniary loss as a result of the breach. And so it has to have --

THE COURT: What about that string of cases in the

New York Court of Appeals going back to Judge Desmond in 1943, if somebody fails to disclose that they have a -- I don't know whether it was --

MR. SACKS: A medical condition.

THE COURT: A medical condition. It was an ulcer. And then the person died of a heart condition. And they said, recognized the two are not related.

MR. SACKS: Understood.

THE COURT: The ulcer condition had nothing to do with the coronary condition, but it affected risk. Therefore, we're going to deny coverage.

MR. SACKS: We'll get to that, your Honor. But that's a different claim. That's Mr. Forlenza's issue number two. This is issue number one.

Let's keep in context this claim. This is a claim for -- this is not a rescission claim. This is a claim for monetary damages under the terms of the repurchase protocol in the contract. They want to enforce the repurchase protocol. They're not seeking rescission on this claim. They're seeking -- you violated --

THE COURT: They can't seek rescission, can they?

MR. SACKS: They cannot. And we're going to get to that in another minute, your Honor.

THE COURT: As I understand it, they're seeking the equitable equivalent.

MR. SACKS: They are. We're going to get to what as well, your Honor.

THE COURT: I'll wait then.

MR. SACKS: Again, I would like -- and I know there's a risk of this, the risk of the issues getting confused. That's why I think it's important to remember this is a claim that's in their complaint, and it's for monetary damages, not equitable relief, under the terms of the repurchase protocol. And so they must enforce the repurchase protocol in accordance with its terms. And those terms are, at best, ambiguous and they cannot be construed in the way they want on a motion for summary judgment.

So let me go back to adverse because adverse does not, as a matter of law mean, as they suggest it does, with no countervailing reasonable construction that it could in theory affect their risk of loss. Because a theoretical effect on a risk of loss is not something that leads to damages.

They could have said, and we cited to your Honor, there are clauses and cases they've relied upon that don't have the second requirement that there be an adverse effect. So that could have not been in the contract. Or they could have said may have an adverse effect. Or in the Ravens case we cited to your Honor said is reasonably likely to have an adverse effect or something of that sort. But it doesn't say that. It must have an actual adverse effect on the interest.

That construction, your Honor -- if you don't want to accept it now, that's fine. But you can't say it is an unreasonable and untenable construction as a matter of law on a summary judgment motion. They have offered no evidence to suggest that that's not a reasonable construction.

In fact, it is the right construction. But if we have to present evidence on it, we'll present evidence at trial as to the purpose and intent of these type of clauses and why, in fact, that's the right construction of this, and why you only repurchase things that have an economic effect but not things that might in theory have an economic effect. If that's necessary.

But you can't reject that on a motion for summary judgment which is what they're suggesting your Honor do. Again, it has to be something that their construction is the only possible construction as a matter of law.

Their construction would read adverse effect out of this agreement and say if you have a material breach of a rep and warranty because those affect our insurable interests, then you've breached this. There is no need for an adverse effect. There is de facto an adverse effect upon a breach of a rep and warranty.

That's not what this clause says. There are two requirements: Breach, adverse effect. They want it to be read out of this contract.

The obligation -- and it makes sense in this context. Because the obligation to repurchase doesn't arise until there has been an actual adverse effect which is when the clause is triggered by giving notice. You don't give notice, again, in a vacuum. You give notice when something happens that affects you.

The purpose of this clause. Your Honor, you can look at this, again, if -- it is to protect them from the economic harm that would affect the interest that they assumed in this contract.

Further, your Honor, if you look at what I've handed up to you --

THE COURT: I was waiting for that.

MR. SACKS: They rely on extrinsic evidence.

The housing market is going to be referenced later.

But if you look, your Honor, at the third page.

THE COURT: Okay.

MR. SACKS: Their own witness has testified to a construction that is the construction we say. Their own witness, this person who is their head of surveillance, the person who is responsible for overseeing the performance of the loans in their trust. She's testified as saying that if you have a loan that was an exception to an underwriting guideline and you never suffered a loss associated with that loan, you then do not have the right to --

THE COURT: I guess she wasn't prepared for Mr. Forlenza.

MR. SACKS: Perhaps that's the case, your Honor. But, again, we're here on summary judgment in the face of testimony from the person who is their witness, who is their head of surveillance that endorses our construction of this contract. How can you grant summary judgment on their interpretation? It doesn't make sense. This is not a summary judgment point for them, your Honor.

I can go into the cases if that's necessary. I can go into other points if your Honor --

THE COURT: What's your best case, Mr. Sacks?

MR. SACKS: Our best case on this point -- I don't know that there is a best case. I would say LaSalle v. CIBC. LaSalle v. Citicorp. And, indeed in a case that they like for another purpose, and though I wouldn't like to tout Justice Bransten's rulings generally, she found that a similar clause was subject to disputes and was not susceptible to interpretation on summary judgment in their case six months ago.

THE COURT: All right. Thank you very much.

MR. FORLENZA: May I have one minute, Judge?

THE COURT: One minute for reply. And then we have to go into the rescission area.

MR. FORLENZA: Precisely. Very quickly, Judge.

We're not talking about potential risk -- sorry potential adverse effect. When a loan is riskier than warranted, there's an actual adverse effect. That's the reason, as you pointed out, we got the warranties. If there are 71 warranties saying the risk attributes are X, the insurance company makes a decision to submit itself to six hundred million dollars of exposure for a million dollar premium, and it turns out that these warranties are all incorrect or worthless in terms of accuracy. To suggest that an insurance company is not adversely affected by that I think makes no sense whatsoever.

THE COURT: What about Ms. Brunie's statement?

MR. FORLENZA: First of all, she's not a 30(b)(6) witness.

THE COURT: Isn't she a managing director?

MR. FORLENZA: Yes, but she testified she had no responsibility for making these decisions. It was counsel's decision. In other words, she was not the person who had knowledge of this. She gave an opinion about what she didn't have any real knowledge. And we made that point in footnote six of our reply brief.

Finally, I want to make this very important point about damages. Because there's a real symmetry, your Honor, between the language and purpose of the protocol and the remedy in the protocol. It says when the adverse -- when the breach

adversely affects the interest, you cure, replace, or repurchase. That's not a damage claim.

We're asserting that there was an utter frustration of the repurchase protocol. Had it been lived up to, it provides in the protocol that the repurchase price is the outstanding principal. So we did a model based on what would have been paid.

But I want to say that again. The adverse effect simply triggers the remedy of cure, replace, repurchase.

It's a pure question of law. And those two cases I cited Judge, we'll send you the citations in our brief.

THE COURT: What about rescission now?

MR. FORLENZA: Okay, Judge.

Give me one second, please.

This I can do shortly, Judge.

The issue here is whether Syncora is entitled to the monetary equivalent of rescission where we establish there are massive breaches of warranties on this big exposure, that Syncora would ordinarily be entitled to rescission for a material breach, which would put it back in the position that it would have been in had it not issued the policy. But they issued an irrevocable policy having relied on these warranties because, after all, the noteholders are innocent and have no relation to anything --

THE COURT: Let me ask you, Mr. Forlenza. I know that

Mr. Sacks won't agree with this. But say you prevail on the first issue, why do you need rescission then?

MR. FORLENZA: Well, Judge, at some point we're going to have to elect remedies. And I'm not sure where that point is. We're looking into that. But there are two ways of getting to, you know, pretty much the same result.

THE COURT: What do you say if Mr. Sacks has not convinced me in the first argument and you're entitled to summary judgment, but here on rescission you haven't convinced me that you're entitled to rescission or the equitable equivalent of rescission?

MR. FORLENZA: Assuming I haven't, then your question is what, Judge?

THE COURT: The question is if you have one what do you need the other one for?

MR. FORLENZA: Well because all we're asking for on the first one is a ruling as to what their obligations are and how -- and that they've breached them by not taking them back.

We then have to prove, with every loan -- well with a sample that, in fact, there was a material breach. In other words, we're not asking for rulings that, you know, in fact, they have breached. We're just saying what's the legal standard.

We're going to have to prove that. And we're going to have to do a damage model that your Honor accepts. So it's

crucially important that we have both because we have no guarantee that we'll prevail on the first either establishing a sufficient breach rate that gets us up to a meaningful number. So we really do need both. Two critical claims of ours.

THE COURT: Well I know they're critical and you believe they're important, but I don't know when this case is coming on for trial.

It's coming on for trial in 2013?

MR. FORLENZA: Yes, sir.

THE COURT: Why do I have to decide this before the eve of trial?

MR. FORLENZA: That's a good question. Because we are just about to wrap up fact discovery. We're starting to get involved with expert reports, and then we'll have depositions. And what the -- the position they take is you cannot get any relief under the material breach of contract claim without showing causation; i.e., this breach affected and made this loan default.

Now, if -- we're about to start taking borrower depositions. We've got documents. Borrower depositions. We intend to simply be pretty straightforward. Did you lie, you know, what your income was, etc., etc.

If we have to go into, which is what they say our burden is, all the circumstances, track down each borrower and say all right what were the circumstances that led to your

decision not to pay the mortgage but to pay the credit card instead, that's the burden they want to place on us. And the reason that that's not appropriate in this case is under common law, under New York insurance law, under equitable principles, the whole purpose of rescission or rescissionary damages is to put particularly an insurer back in the place it would have been in had there not been an insurance policy. And that's based on, as I say, common law, 3106 of the insurance law.

The point, Judge, is that particularly with insurance companies, warranties are conditions precedent. And if you look at 3106(a) of New York insurance law it points out that they're conditions precedent to the taking effect of a contract or a condition precedent to the liability.

Judge, I would submit that it's pretty clear that if we prove that they have massively breached the loan level warranties; if we prove, as alleged, that they have breached the transactional level warranties; if we prove that they have frustrated by buying back, what, I think one-and-a-half percent of the 1300 loans.

THE COURT: It's less than that.

MR. FORLENZA: I think it is.

Clearly it's a material breach of contract. That entitles us or would entitle us to rescission.

And what a number of courts before January, not including New York, and now with Justice Bransten including

New York, there's precedent saying look in a situation where an insurer has issued a policy on a mortgage-backed security transaction and did so on the basis of warranties that were inaccurate, it would be ordinarily entitled to rescission. But where rescission is impractical or impossible, the Court has the equitable power to be flexible and grant in its discretion monetary relief that is the functional equivalent of rescission; that is to say: How do you put an insurer back in the place it would have been in had it not issued the policy?

The case you mentioned -- I didn't remember it was Justice Desmond, but I think it was the Glickman case in 19 whatever.

THE COURT: 43.

MR. FORLENZA: Yes, sir.

Exactly that situation. And even more to the point there's a case called Levine which we discuss in our brief, Judge, and that's right on the money in this sense, Judge.

THE COURT: Is that the one with the light on the boat and the lake?

MR. FORLENZA: That's the boat and the search light case, Judge?

THE COURT: Yes.

MR. FORLENZA: Exactly.

So the point that the Second Circuit made is, look, the warranty was that this boat would have a search light. The

boat hits an obstruction that's underwater. And the jury concludes the search light would not have found or seen it. So there was no causal connection between the breach of warranty and the loss. There had to be a causal -- a connection between the warranty and the general risk; i.e., hitting obstructions. So it's perfectly clear that under Second Circuit authority and New York law you don't have to show a causal connection with a breach of warranty in an insurance contract.

Then I want to make one other point that I think is critically important. The Second Circuit in two decisions, one back in 1937 which is Ginsberg and one in Mutual Benefit in 1988, we mentioned. They talk about the strong public policy in New York of not allowing insurance applicants to obtain insurance with false or inaccurate warranties and then getting any benefit under the policy, putting the insurer in a place -- position of having to pay anything.

And the Second Circuit in Mutual Benefit said that to allow that would, quote, reward the practice of misrepresenting facts critical to the underwriter's task, and the applicant would have everything to gain and nothing to lose from making material misrepresentations in his application for insurance. Quote, New York does not permit this anomalous result.

Even more to the point. In Ginsberg, back in 1937 right on causal connection. The Second Circuit said: If you were to require insurers, when there's a breach of warranty --

maybe that was a misrepresentation, but the same concept -- when they issue a policy based on facts that aren't true, if you require them to show a causal connection, then what you're doing is you're rewarding the applicant who has breached the warranty.

And it uses this language. Right on the money. It says, "The insured could freely misrepresent information specifically requested and still recover on the policy if the causal connection could not be traced." It's right on the money.

Now let me tell you what we're asking for, because actually we were very conservative -- I was going to take you, I don't have enough time to take you through Justice Bransten's decision.

THE COURT: I'll read Judge Bransten.

Is it on appeal?

MR. FORLENZA: Yes, sir and I'm quite -- well, it is.

THE COURT: It hasn't been argued then?

MR. FORLENZA: October term, as I recall.

The point, Judge, is we have actually asked for a rather conservative ruling from your Honor: Simply, that this Court, a federal district court, has the power, within its discretion, under these circumstances if we prove our case, prove that legal damages are inadequate, we prove all that, this Court simply has the power to grant that relief. You can

do it on a full record. We're not asking for a ruling.

Justice Bransten actually went further and said if Syncora and MBIA prove their case against Countrywide, they are entitled to rescissionary damages. We've asked for something more conservative. Maybe if that decision would have come done before we drafted our declaration I wouldn't have been so conservative. But it's a very conservative request.

And the reason we want this part of the case, Judge, it really will affect the way we're going to have to prepare this case and try this case if, in fact, your Honor ruled, which I would find surprising, that you actually do not have the power as a court of equity to grant the relief that you think is appropriate.

THE COURT: Thank you.

Mr. Sacks.

MR. FORLENZA: Thank you very much.

MR. SACKS: Thank you, your Honor.

Your question is why do you have to decide this now.

THE COURT: Yes.

MR. SACKS: You don't have to decide this now. Not only do you not have to decide it now, you shouldn't decide it now. They're asking you hypothetical questions about a Court's hypothetical equity power. An equity power is discretionary within the Court in terms of all of the facts and circumstances --

THE COURT: Well don't I have that power?

MR. SACKS: Of course you have that power. You have the power as a court of equity to do equity within the bounds of your discretion. You shouldn't be issuing any rulings about what if this then that maybe this. You don't have any evidence.

Equity is power that you exercise in light of the evidence that's presented to you and in light of a variety of different principles when damages, legal damages are inadequate as a matter of law. They haven't even met the first test. Because they're asserting damage claims in this case.

So, you may conclude damages are -- well, first of all, you may conclude they're entitled to nothing because, again, you understand we fundamentally dispute this notion of all these breaches. They presented zero evidence of it. So you may decide --

THE COURT: Your theory is that, I guess it's on the front page, the collapse of the U.S. housing market. That's what caused Syncora's difficulty.

MR. SACKS: Absolutely.

THE COURT: It wasn't breaches of representations of warranties that caused the difficulty that Syncora is experiencing.

MR. SACKS: Absolutely. It was the risk they agreed to insure. Specifically no one in their right mind -- no one

at that point in time thought that the housing market was going to collapse 35 percent right after they insured this transaction. And nobody thought that the California housing market was going to collapse 45 percent. And 55 percent of these loans were in California.

There is no question, in our mind at least, and that's what the trial will be about, as to what caused the losses in this. They had nothing to do with these breaches that they are claiming.

THE COURT: Mr. Sacks, I asked you the first time you were up about the -- those cases by Judge Desmond and Judge Hand and you said I was getting ahead of myself.

MR. SACKS: Correct.

THE COURT: So.

MR. SACKS: Can I address those?

THE COURT: Yes, please.

MR. SACKS: But can I address them also, your Honor, in the context of those are -- first of all, they rely on these several three -- two or three very old cases. Those are cases --

THE COURT: Old law is good law.

MR. SACKS: Maybe or maybe not. Maybe or maybe not because there's more recent law that suggests a different outcome.

But, your Honor, those are rescission cases in the

first instance. I want to take this in two steps, first of all.

THE COURT: I thought you were going to tell me there are also cases that were after trial.

MR. SACKS: No. That's not going to be the basis -- could be another distinction. That's not the fundamental one I'm going to give to your Honor. Those are rescission cases, your Honor.

While you have broad equitable powers, I believe you do not have the power in this case to grant them rescission because they have contractually agreed that they may not have rescission in this case. And if they've agreed they can't have rescission, you can't award them the equivalent as rescissionary damages.

If you look at the charts, your Honor, it's a case that they cited in another context. The last page of this, rescission was found to be -- basically describes that rescissionary damages are the economic equivalent of rescission in circumstances where rescission is impractical.

This is not a case where rescission is impractical.

THE COURT: It's impossible. It's not legally viable.

MR. SACKS: They've waived their right to it.

THE COURT: But what about the cases that they cite? An insurer goes in he says -- doesn't disclose the ulcer problem. They find out about it. And he dies of a coronary

disease. And the Court says, New York Court of Appeals, Judge Desmond, who is a very young man, says doesn't make any difference. It affects the risk profile. And Judge Hand says the same thing.

MR. SACKS: Your Honor, the more recent cases say that the reason that -- we cite you to -- let me find the cases. I apologize. It's Anjay, I believe is one, and the other is -- apologies.

THE COURT: Anjay Corporation.

MR. SACKS: Anjay and Nunez are the two that we cite, are more recent appellate division cases, which in looking at this, looked at whether the reason for the loss is causally connected to the breach of a warranty.

They argue these fit within 3106(b)'s exception for multi-peril insurance.

First of all, your Honor, I do want to take a minute and explain why 3106(b) doesn't apply here, I think it's important.

But it is no more multi-peril than this particular case is. In those cases, it was property damage. And they concluded in Anjay that a breach of warranty relating to video surveillance didn't give him a basis to rescind when the damage to the property occurred because of an explosion.

And in Nunez it was a breach of warranty relating to the existence of fire extinguishers didn't provide a basis to

rescind where the property damage to the apartment occurred as a result of water from a fire upstairs. There was no nexus between the two.

These are more recent cases, an '06 and a 2011 appellate division case. And what they illustrate is that the harsh rule that you're looking at in those other cases is not the rule, number one.

Number two, that is a rule that would justify rescission which they can't get in this case.

Number three, those are cases where they were using it as a defense to payment on the policy. Here, this is not -- nobody is seeking to avoid payment on the policy.

THE COURT: This is your sword/shield distinction.

MR. SACKS: Correct, in part, your Honor.

But in this particular case, your Honor, if you look at it, you have to look at the -- let me -- we do not contest that you have broad equitable powers subject to the limitations -- and I think we should argue the limitation at trial when you hear all the evidence about the contract and what they did and didn't agree to. We will argue that your powers have to stop short of rescission because they agree that they could not seek rescission.

They also can't get rescission because they haven't named any of the other parties to the contract. 3106 doesn't apply because I think the contract they're seeking rescission

of isn't an insurance contract. The I&I agreement isn't an insurance contract. The policy is an insurance contract. My client is not a party to the policy. They're not seeking rescission or rescissory damages on that. They don't have the parties to the policy here. They don't have the other parties to the I&I agreement here.

THE COURT: Tell me then, Mr. Sacks, assuming that Syncora is right and that the representations and the warranties are false, what is the remedy?

MR. SACKS: The remedy is that any of the representations and warranties --

THE COURT: That result in a loss.

MR. SACKS: That resulted in a default of a loan or other loss.

THE COURT: Of a particular mortgage.

MR. SACKS: Well it's a particular mortgage. But I'm not telling your Honor that they necessarily have to try the case mortgage by mortgage.

Your Honor is very clear about that. There may be ways to extrapolate. There may be ways to sample. We haven't yet had evidence and discussion about what samples may or may not be appropriate; what they can -- I'm not saying they can do it. I am not saying that they are necessarily precluded. That's something that we're going to have to discuss with your Honor at some point in time.

They could arguably do it by having people look at the mortgages they've claimed on. Remember, they've claimed on 1600 mortgages or something like that. Remember, the testimony I just cited to your Honor said the -- they understood that seven hundred might be subject to problems. So, how many of them are or are not defective?

People understood that this was a process that was going to involve looking at the circumstances of individual mortgages because the reps and warranties they contend were breached go to the circumstances of individual mortgages. In loan number 106, they repped and warranted that the buyer -- the borrower didn't commit fraud. The borrower committed fraud. That goes to that loan. You can't look at loan 108 to determine what the borrower under 106 did. That's the nature of this transaction. It's the nature of the reps and warranties. But that doesn't mean your Honor at a trial needs to sit through all of that. There are many ways to do that through experts and summarization and things of that sort so that your Honor is never going to have to sit through and listen to all of that in this particular case. So I wouldn't worry about that.

But your Honor, in answer to your question, if they show that there was a breach of a rep and warranty that had -- that caused them to suffer any damage, they get to recover for it in this case. If we fail to meet our repurchase obligation,

they can recover in monetary damages from us for it. They can prove that. They've got claims for it. And we don't believe that there's going to be any basis for equitable relief in this case.

They're not going to show that we had more knowledge of these loans than they did. They had the same knowledge about these loans as we did. It's a risk allocation issue in this contract.

They're not going to show, notwithstanding their puffery in these briefs, they have utterly no evidence of it, that we committed fraud.

And remember, your Honor, you refused to allow them to assert a fraud claim in this case. So we're sitting here seeking remedies that are effectively fraud-based remedies in a case where your Honor has ruled they can't bring a fraud claim.

They brought that claim across the street in state court. You've said that they couldn't amend to bring a fraud claim here. We're looking at fraud-based remedies. You look at Glickman --

THE COURT: Is that what Judge Bransten ruled on?

MR. SACKS: No, not in our case. No, no, no. Not in our case. We have Justice Ramos in our case, your Honor. So he hasn't ruled on any of these issues at this point in time.

But they've brought a fraud claim across the street. They shouldn't be looking at this in this particular case to

essentially assert the same remedy.

Let me spend one minute on 3106, if I could.

THE COURT: Yes, please.

MR. SACKS: Which is an insurance clause.

It applies to warranties in an insurance contract only.

First of all, it's a consumer protection statute that limits the ability of an insurer to rescind. Again, it's a rescission issue. It only speaks to rescission, which they waived. But even if you want to overlook that, it is a statute that limits the insurers right to rescind. It doesn't give it affirmative rights beyond the law.

And an insurer, like everybody else, is subject to the normal rules of equity jurisprudence. You want equitable relief, you have to have no adequate remedy at law. And in these older cases, indeed, you look at it and you get rescission. Well, of course, there is no remedy at law other than rescission because they didn't want to pay on an insurance contract. It makes perfect sense.

Here, they have a remedy at law. The contract provides them with effective, carefully negotiated remedies at law. So, that's number two. They still have to meet that.

Number three, it applies only to rescission of an insurance contract and the warranty has to be in the insurance contract.

They keep talking about rescission and rescissory damages. I don't know what contract they think they're getting rescissory damages on or rescission on. But there is no warranty in the insurance agreement contract here. That is the policy. It has no warranties.

If you look at the attachments here, your Honor, it expressly says there are no warranties. It is nonrescindable. No restrictions or conditions --

THE COURT: Mr. Sacks, are you saying I should look at the attachment?

MR. SACKS: I'm sorry. In the demonstratives I handed up to your Honor, if you look at the next to the last page, fourth page, it cites several excerpts from the insurance policy, which precludes cancellation, revocation, or rescission. There are no conditions --

THE COURT: This is the insurance policy issued to the -- by the insurer to the noteholders?

MR. SACKS: Correct.

THE COURT: Okay.

MR. SACKS: And that's what they want to -- all the damages they're asking for in the form of rescissionary damages are amounts they paid under this policy.

They didn't pay us any money. No money was paid to my client. It's all money they paid under this policy that they agreed they wouldn't rescind.

So are they seeking rescissionary damages under that policy? That's the insurance contract. But that contract has no warranties in it.

3106 only applies to warranties in an insurance contract. The warranties here that they are referencing are different contracts. It's the I&I agreement.

The I&I agreement is not an insurance contract. It doesn't convey insurance to anybody.

There are two different agreements.

Now, I don't know what they're -- they're trying to fit a square peg in a round hole. They're trying to cite to your Honor law that they like but under the guise -- listen, you will hear the evidence at trial. If you believe, subject to the limitations of their agreement that they can't get rescission, that the facts justify equitable relief because monetary damages are not appropriate, that's what you'll determine, based on the evidence that's presented.

But the notion that you can determine in the abstract with no evidence -- there is no evidence on this motion that equitable relief might, could, or how you would decide to exercise equitable discretion which this Court has, based upon hypothetical facts that may or may not be shown, but only one side of the hypothetical facts, without consideration of the other facts that bear upon all of the facts and circumstances and bear upon the equities, that's not something that can be

determined in an abstract hypothetical ruling in a vacuum, so to speak.

The Court only exercises its equitable discretion in light of the facts, all of the facts that are presented to it. They want to present you with a couple of facts on this motion.

And they're not even presenting you with facts. They're presenting you: If we show this. Not that we've shown it. But if we show these two things, then you have the power to give us this.

Well, what if we show all these other things? What if we show that none of these loans have to do with it? What if we show that none of these were material breaches? What if we show that there were only 40 material breaches, way less than the seven hundred they said? What if we show they had as much knowledge as we did? What if we show that we were as harmed as they were? What if we show that we went out of business because of transactions like this one, that nobody did anything wrong? Those are all equitable facts and circumstances. And they can't get a hypothetical ruling on a motion like this as to how a court will or will not exercise its equitable power.

The only point I will make is that to the extent they are actually seeking rescission or its equivalent, rescissionary damages, you can rule that they cannot get that particular form of relief because contractually they agreed that they would not seek that form of relief.

THE COURT: Thank you.

MR. SACKS: That's a legal issue. Beyond that, within the scope of your equitable powers, that's for trial, your Honor.

THE COURT: Thank you, Mr. Sacks.

Mr. Forlenza.

MR. FORLENZA: Yes, very briefly.

THE COURT: Very briefly.

MR. FORLENZA: On the last point, it is absurd to suggest that we agreed we wouldn't seek rescissionary damages from the applicant. The irrevocable policy was for the benefit of the noteholders.

THE COURT: Wait a minute.

I understand Mr. Sacks as saying that 3106 applies to insurance contracts.

MR. FORLENZA: Yes, and the --

THE COURT: I&I is not an insurance contract.

MR. FORLENZA: I think it is, Judge under -- when you read the provisions of 3106.

THE COURT: Who are the parties to the I&I?

MR. FORLENZA: It is the --

THE COURT: You and?

MR. FORLENZA: Syncora.

THE COURT: And EMC.

MR. FORLENZA: The sponsor. EMC. Yes, your Honor.

The point is the I&I and the insurance policy are integral. They are a related, integrated contract. That is to say, under the I&I we are required to issue the insurance policy. We got all the reps and warranties for one purpose. The one thing that we do is we issue the insurance policy. Of course you've got to look at both of them as related, I submit, as a related contract, which is an insurance contract.

THE COURT: Okay. Go ahead.

MR. FORLENZA: Secondly, we are not seeking fraud relief. Mr. Sacks is not addressing that the remedy for breach of warranty, a material breach of contract, is either rescission or rescissionary damages. That's a breach of contract remedy.

Now, Mr. Sacks says that 3106 is a shield, not a sword. And he keeps saying it only relates to rescission.

Actually, it says that you may, on a breach of warranty, an insurer may void the contract, rescission, or defeat recovery, or defeat liability. And that doesn't mean just a defense to a claim. Under the Kirton case, it includes getting a money damage award for claims already paid. The Kirton case.

But let me make this very clear. We do not seek rescissionary damages under the authority of 3106. We say, as Justice Bransten found, that the Court, sitting in equity, is informed by 3106 because 3106 makes it very clear that the New

York state policy in insurance cases, is that if you have a breach of warranty that materially increases the risk of the loss, the remedy is to keep the insurer free of any liability whether through rescission, avoidance, or recoupment. That's just the policy.

That raises the question when your Honor is deciding whether it's appropriate to give rescissionary damages, you take it into consideration. But it's your equitable power that gives us the ability to ask for that relief.

I think that's it, Judge.

THE COURT: Wait a minute. You have a further communication.

MR. FORLENZA: Forgive me. My partner points out if you look at section 3.01 of the I&I agreement, that's where it makes it clear that it's a predicate and the whole purpose of this I&I from the insurance perspective -- the insurer's perspective to issue the policy.

And frankly, Judge, to try to tease away the I&I agreement which says you, the insurer, have one thing to do, issue a policy, take on the risk of $600 million, and do so based on 71 warranties, and then say --

THE COURT: So the point you're making is the insurer agrees to issue the policy subject to satisfaction of the conditions precedent which are the reps and warranties.

MR. FORLENZA: Precisely.

THE COURT: Set forth below on or prior to the closing date.

MR. FORLENZA: Precisely.

You can't tease these two agreements apart. That's the whole point of the insurance and the insurers role in this.

So to suggest that they could breach all of the warranties with 85 percent of the collateral that is the sole source of the funds for the insurance company's $600 million exposure and to say, well, they really don't have anything to do with each other.

Thank you, Judge.

THE COURT: Thank you very much, Mr. Forlenza.

I'll get to this promptly. Thank you.

(Adjourned)